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OAO NOVATEK

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OAO NOVATEK

Major Rating Factors

Corporate Credit Rating
BB+/Positive/--
Russia National Scale Rating *ruAA+/--/--*

Strengths:

- Robust financial metrics.
- Low-cost producer.
- Large reserves of natural gas.
- Diversified between gas and liquids.

Weaknesses:

- Low domestic gas prices.
- Dependence on Gazprom pipeline infrastructure.
- Geographically concentrated operations.
- Russian country risk, including uncertain enforcement of tax and regulatory rules.

Rationale

The rating on Russia-based independent gas producer OAO NOVATEK reflects the company's dependence on the pipelines of state-controlled OAO Gazprom (BBB/Negative/A-3), the dominant player in the sector with 84% of the country's gas production, ownership of the gas distribution system in Russia, and a monopoly on exports. Further rating constraints are the geographic concentration of its operations and low domestic gas prices. In our view NOVATEK is also exposed to the risk of operating in Russia, including uncertain enforcement of tax and regulatory rules and the volatile U.S. dollar/Russian ruble exchange rate.

These weaknesses are offset by healthy credit metrics and the company's high profitability. NOVATEK's position as Russia's largest independent natural gas producer and its long reserve base underpin the rating. OAO Gazprom owns 19.4% of NOVATEK, which in our view reduces pipeline infrastructure risk.

Key business and profitability developments

In the first half of 2009, total natural gas production stood at 15.7 billion cubic meters (bcm), up 5% compared with the same period of 2008. Although growth rates are lower than previously recorded, we notice a clear difference with most other Russian gas producers which have been reporting shrinking volumes due to a significant decline in domestic and EU gas demand.

In 2009 NOVATEK has continued to demonstrate its ability to manage domestic gas industry risk, including very low domestic gas prices and its operational dependence on Gazprom. Although we continue to view these risks as key rating constraints, NOVATEK has a long track record without any operating setbacks. In addition, we view Gazprom's 19.4% ownership of NOVATEK as a strong mitigating factor. Gazprom is represented by two directors on NOVATEK's board and has approved key strategic moves, such as the acquisition of a stake in OAO Yamal LNG in May 2009.

Low domestic gas prices, which are significantly lower than international benchmarks, greatly affect NOVATEK's profitability. Although NOVATEK's prices are not regulated, they indirectly depend on Gazprom's regulated prices, which the government sets at very low levels. Nevertheless, Gazprom's prices increased by about 20% in 2008 in Russian ruble terms and a further 15% increase in regulated gas prices in 2009. We therefore expect NOVATEK's gas price realization to increase further. In the first half of 2009, about 65% of revenues came from domestic natural gas sales, with the remainder coming chiefly from other oil products such as crude oil and stable gas condensate (35%). Even at low prices, NOVATEK's gas business generates positive profits; the company had an EBITDA margin of 40% in the same period, chiefly thanks to very low costs. NOVATEK's reliance upon the regulated domestic gas price is partly mitigated by sales of crude and condensate at market prices.

Key cash flow and capital-structure developments

In the first half of 2009, NOVATEK generated funds from operations (FFO) of Russian ruble (RUR) of nearly 14 billion ($450 million). Changes in working capital were small, and cash flow from operations therefore easily covered both capital expenditures of RUR7.7 billion and dividend payments of RUR1.5 billion. The company's key credit ratios remained strong. Total debt stood at RUR41.5 billion on June 30, 2009, with annualized FFO to debt of about 87%. We note that the company is exposed to foreign exchange risk: about 62% of its revenues are denominated in Russian rubles and about 70% of its long-term debt in U.S. dollars.

Although the company plans capital spending of about RUR18 billion in 2009, after having completed two large projects in the fourth quarter of 2008 (the second phase of the Yurkharovskoye field and the second phase of the Purovsky plant), we take comfort from the fact that only a small part of the spending program is now committed. Although capital spending may still be high, we expect that management will act to ensure that net debt to EBITDA remains at about 1x over the cycle. We don't expect any further major acquisitions following the acquisition of a 51% stake in oil and gas exploration and production company OAO Yamal LNG in May 2009.

Of the total $650 million consideration to be paid for the acquisition, we understand that $550 million will be paid through a combination of cash and new debt (already issued).

Liquidity

We consider NOVATEK's liquidity position to be somewhat weak. Cash in hand stood at RUR8 billion ($255 million) on June 30, 2009. We understand that the company has access to committed credit facilities of about $350 million, but those credit lines have short maturity terms (within one year). We further understand that the company is in the process of signing further facilities of about $300 million. Once this has been confirmed, we will factor it into our credit assessment if they are committed. On June 30, 2009, short-term debt and the current portion of long-term debt stood at RUR22.7 billion ($734 million), but we understand that the company refinanced about one-half of this amount in August. A longer-term financing would help underpin the credit profile.

We expect the company to remain in line with its key covenants: net debt to EBITDA below 3x and EBITDA interest coverage above 4x.

Outlook

The positive outlook reflects our view that a one-notch upgrade may be warranted in the short to medium term, provided NOVATEK's business model continues to enable the company to maintain its sales volumes. However, this would require NOVATEK to continue to demonstrate a prudent financial policy, keeping net debt below annual EBITDA and adjusting its capital expenditure accordingly.

On the other hand, were volumes to decrease or profitability to decline for any reason, we would probably revise the outlook to stable. Financial policy slippages, adverse regulatory changes, or evidence of operational risks such as adverse tariff or taxation moves, or restrictions on access to gas or condensate transportation could put downward pressure on the outlook or ratings, although we do not consider this in our base-case scenario. We do not factor in further significant acquisitions in 2009 and factor in only minor acquisitions in 2010.

Business Description

NOVATEK is the largest independent gas producer in Russia. In 2008, it produced 30.4 bcm of natural gas and 2.6 million tons of liquids. NOVATEK's production is mostly concentrated at three 100%-controlled fields in Yamal-Nenets Autonomous Okrug (BB+/Stable/--; Russia national scale 'ruAA+'), the main gas-producing province in the Russian Federation (Local currency BBB+/Negative/A-2; foreign currency BBB/Negative/A-3; Russia national scale 'ruAAA'). NOVATEK's shareholding structure is as follows: 19.4% Gazprom, 44.1% management, and 36.5% free float.

Business Risk Profile: Fair On Inherent Russian Gas Risk, Mitigated By Low Cost Profile And Long Reserve Replacement

The major constraints for the "fair" business risk profile are

- Operational dependence on Gazprom's pipelines. Although NOVATEK has never experienced any difficulty gaining access pipelines, we continue to view this is a key risk for the company. We note that the company's growth plans depend on access to Gazprom's pipeline capacity. Although Russian legislation requires Gazprom to grant pipeline access to independents, other independent gas players have had difficulty accessing Gazprom's infrastructure in the past.
- The risk of lower gas demand during economic downturns. So far NOVATEK's sales volume has been unaffected (even increased year-to-year). In contrast, many other operators have experienced volume decline and we don't rule out NOVATEK's being hit at some point.
- Low domestic gas prices (see table 1). NOVATEK's prices are not regulated, but its gas prices depend indirectly on the very low prices set by the Russian government for Gazprom. Historically, regulated prices for end customers have been well below European benchmarks.

Table 1

OAO NOVATEK Gas Prices

RUR/thousand cubic meters	2006	2007	2008	second quarter 2008	second quarter 2009
Gas, end customers	1,253	1,505	1,818	1,839	1,886

Table 1

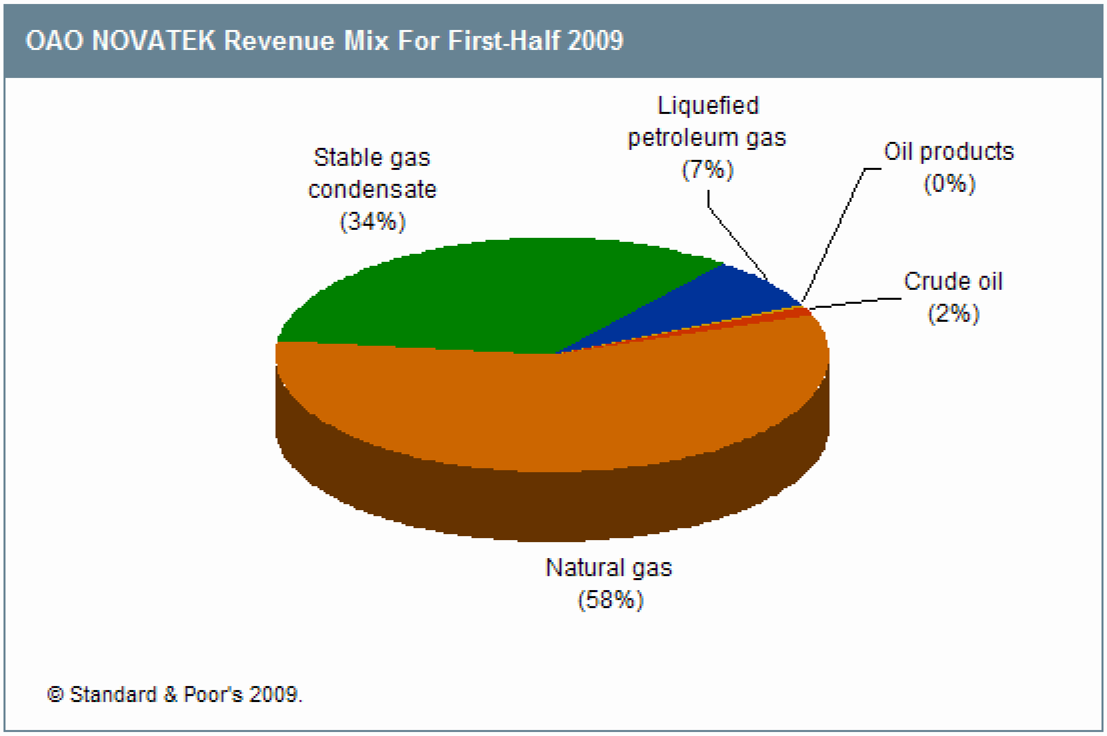
OAO NOVATEK Gas Prices (cont.)					
Gas transportation expense	516	631	718	748	983
Netback	737	874	1,100	1,091	903
Gas ex-field (wholesalers)	664	779	979	970	1,027
Novatek's netback differential (end customers minus ex-field price)	73	95	121	121	(124)
Regulated gas price in Novatek's regions	1,110	1,274	1,563	1,593	1,755

RUR--Russian ruble.

- A relatively high share of production (56%) from the Yurkharovskoye field. We view the company's production and reserves as concentrated. In 2008, its three largest fields (East Tarkosalinskoye, Khancheyskoye, and Yurkharovskoye) accounted for 99% of its production. This concentration promotes economies of scale and reflects the geological features of NOVATEK's core operating region, but highlights the company's exposure to the logistical risks of a single region.

These constraints are mitigated by:

- NOVATEK's long, positive track record of cooperation with Gazprom. Unlike some other independent gas producers in Russia, the company has never experienced substantial distribution interruptions. Gazprom's 19.4% ownership interest in NOVATEK strongly mitigates the risk of disruption to pipeline access. Accordingly, Gazprom can exercise a degree of control over NOVATEK's investment and growth plans. In our view, close coordination with Gazprom's own plans is beneficial for NOVATEK's credit profile.
- Gazprom's strong interest in having independent suppliers like NOVATEK sell natural gas on the domestic market. Gazprom holds the Russian gas export monopoly, but still has to ensure the domestic market is served. Independent suppliers need to invest in developing their smaller fields to satisfy an increasing share of domestic demand at low prices. In our opinion, this allows Gazprom to free up volume for lucrative exports, inure domestic customers to higher gas prices, provide an alternative to relatively costly gas imports from Central Asia, and effectively "outsource" part of its capital expenditures to independents. In our view, this creates a niche for independent players such as NOVATEK. We believe that independents will meet an increasing share of Russia's domestic gas demand.
- Increasing gas prices. Although Russian domestic gas prices still are low compared with those of Western Europe, we believe that there is political and regulatory support for progressive gas price increases; the tariffs increased by 15% in 2007, 25% in 2008, and 15.7% in 2009 (visible by quarterly increases). Moreover, despite the economic crisis, politicians appear committed to the liberalization program. We view downside gas price risk as low (see chart): 65% of NOVATEK's revenues were from natural gas sales in first-half 2009 compared with 55% in firsts-half 2008). Russian oil and gas companies are also less sensitive to commodity price volatility than their international peers due to taxation and foreign exchange effects. For further details see "Russian Oil And Gas Companies: Drop In Cash Flows Only Partially Mitigated By Ruble Depreciation And Tax Regime," published on March 17, 2009, on RatingsDirect.



- NOVATEK's status as Russia's largest independent gas producer. The company contributes about 30% of total independent production. It is the main gas supplier to large industrial regions such as Tyumen Oblast (not rated), Samara Oblast (BB+/Negative/--; Russia national scale 'ruAA+'), and Sverdlovsk Oblast (BB/Stable/--).
- NOVATEK has a solid reserve life of about 23 years, plus potential upside from probable and possible reserves (see table 2). At year-end 2008, the company's proven reserves totaled 4.96 billion barrels of oil equivalent (boe) (91% gas). In 2008, the share of developed reserves stood at 83% for gas and 67% for liquids, and the reserve replacement rate was a healthy 230%. Although Gazprom has priority access to new reserves, NOVATEK has been able to acquire smaller assets, which are of limited interest to Gazprom, and has a positive track record of replacing reserves through successful exploration in its core area. The recent acquisition of OAO Yamal LNG provides ground for continued long-term growth and has further boosted probable reserves.

Table 2

OAO NOVATEK Proven Reserves

	2004	2005	2006	2007	2008
Proven reserves (mil. boe)	4,108	4,573	4,665	4,677	4,963
of which gas (bil. cubic meters)	583	641	651	653	690
of which liquids (mil. barrels)	295	381	407	406	452
Proven developed (%)	65	57	76	82	75
of which gas (%)	67	59	78	84	83
of which liquids (%)	47	35	52	65	67

boe--Barrels of oil equivalent.

- High profitability. This is chiefly thanks to very low production costs and diversification into liquids. Low taxes on gas and condensate production also help offset very low gas prices. In 2008, NOVATEK's lifting costs were only $0.64 per boe and total production costs were only $5.26 per boe (see table 3), which highlights the company's operating efficiency. In addition, NOVATEK's gas and condensate wells have virtually zero watercut compared with about 80% for some Russian oils, and, unlike oil wells, do not need frequent and costly workovers caused by wax accumulation. NOVATEK's costs are gradually increasing, with the key drivers—-including ruble appreciation and regulated transportation costs-—beyond the company's control. Nevertheless, the company has a very substantial margin of safety.

Table 3

OAO NOVATEK Costs And Revenues

$/boe	2005	2006	2007	2008
Revenues/boe	6.68	7.96	10.53	12.38
Costs/boe	3.33	4.13	4.93	5.62
Lifting cost	0.52	0.45	0.58	0.64
Taxes other than income	0.85	1.07	1.19	1.29
Transportation expense	1.16	1.86	2.49	2.92
DDA	0.63	0.62	0.66	0.77
Operating profit/boe	3.35	3.83	5.27	6.76

boe--Barrels of oil equivalent. DDA--Depreciation, depletion, and amortization.

Financial Risk Profile:

The main strength of the "intermediate" financial risk profile are:

- Strong credit metrics, in our view. On June 30, 2009, rolling 12-month debt to EBITDA and FFO to debt stood at 1.3x and 62%, respectively. We expect the credit metrics to remain strong.
- Despite aggressive capital expenditures in 2008 (RUR31.5 billion) Free operating cash flow (FOCF) was broadly neutral, and has been positive (RUR6 billion) in 2009 to date. Although we expect NOVATEK to continue to spend aggressively to increase production (about RUR18 billion expected in 2009), there is no large ongoing project now. We expect the company to reduce capital expenditures, if needed, to honor financial targets. Other than some ongoing pipeline projects to be completed in 2009, future capital expenditures are mostly related to developing drilling, which can be easily delayed if necessary. Standard & Poor's therefore expects capital expenditures to broadly be financed and adjusted according to operating cash flow, and we don't expect major negative FOCF for a prolonged number of years.
- Acquisition risk is now low. Following the $650 million acquisition of OAO Yamal LNG in May 2009, we don't expect further acquisitions this year. Due to the acquisition and dividends, debt has risen and on June 30, 2009, stood at RUR41.8 billion.
- Conservative financial targets. NOVATEK aims to keep net debt below annual EBITDA, although we understand that this threshold can be temporarily breached. The company plans a dividend payout of 30% from 2008 on, which is less than that of some peers.

These strength are mitigated by:

- Short-term debt maturity. On June 30, 2009, short-term debt of RUR22.7 billion made up what we view as a fairly high share of total debt. We therefore continue to view the liquidity as "weak", because back-up credit facilities and cash in hand do not cover debt maturities for 2010. The credit lines available have a short-term maturity (within a year). The long-term debt (RUR17.5 billion; $560 million) matures within two years.
- Some currency mismatch between mostly Russian ruble income streams (62%) and U.S. dollar debt (70%).
- Some commodity price risk. Sales values of crude oil, stable gas condensate, and liquefied petroleum gas (LPG) export sales are volatile according to world markets. LPG contributed roughly 35% of sales in first-half 2009, down from 55% in first-half 2008; mainly due to the decline in the crude oil price.

Financial Statistics/Adjustments

The company reports quarterly under International Financial Reporting Standards. Annual reports are audited, and, until Dec. 31, 2008, the auditor has issued unqualified opinions. Annual and quarterly reports are issued on a timely basis and comparable with those of international peers with respect to timing and detail. Standard analytical adjustments to the company's 2008 financials are relatively small and summarized in table 4

Table 4

Reconciliation Of OAO NOVATEK Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. RUR)*

	--Fiscal year ended Dec. 31, 2008--				
OAO NOVATEK reported amounts					
	Debt	**Shareholders' equity**	**Operating income (before D&A)**	**Cash flow from operations**	**Cash flow from operations**
Reported	26,369.0	96,069.0	36,701.0	31,514.0	31,514.0
Standard & Poor's adjustments					
Postretirement benefit obligations	468.0	(205.6)	(71.0)	(73.1)	(73.1)
Capitalized interest	--	--	--	--	--
Share-based compensation expense	--	--	176.0	--	--
Asset retirement obligations	1,151.4	--	--	--	--
Exploration costs	--	--	1,117.0	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	--
Reclassification of interest, dividend, and tax cash flows	--	--	--	(213.0)	(213.0)
Reclassification of working-capital cash flow changes	--	--	--	--	(2,515.0)
Minority interests	--	571.0	--	--	--
Other	--	--	341.0	--	--
Total adjustments	1,619.4	365.4	1,563.0	(286.1)	(2,801.1)

Table 4

Reconciliation Of OAO NOVATEK Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. RUR)* (cont.)

Standard & Poor's adjusted amounts

	Debt	Equity	EBITDA	Cash flow from operations	Funds from operations
Adjusted	27,988.4	96,434.4	38,264.0	31,227.9	28,712.9

*Please note that two reported amounts (operating income before D&A and cash flow from operations) are used to derive more than one Standard & Poor's-adjusted amount (operating income before D&A and EBITDA, and cash flow from operations and funds from operations, respectively). Consequently, the first section in some tables may feature duplicate descriptions and amounts. RUR--Russian ruble.

Table 5

OAO NOVATEK Peer Comparison*

	OAO NOVATEK	OAO Gazprom	OJSC Oil Company Rosneft	LUKoil OAO	OAO Severstal
Rating as of Sept. 10, 2009	BB+/Positive/--	BBB/Negative/A-3	BBB-/Stable/--	BBB-/Stable/--	BB-/Negative/--
(Mil. $)	**--Average of past three fiscal years--**				
Revenues	2,363.4	99,758.8	35,042.7	69,104.0	16,781.7
Net income from cont. oper.	690.3	25,059.0	9,171.7	8,713.0	1,768.2
Funds from operations (FFO)	858.0	29,040.8	8,527.6	11,474.7	3,133.7
Capital expenditures	683.2	21,005.6	6,425.0	9,182.7	1,743.7
Debt	469.6	46,607.5	22,841.6	9,870.8	3,144.5
Equity	3,062.7	156,337.8	30,138.3	42,074.3	9,393.8
Oper. income (bef. D&A)/revenues (%)	46.8	42.9	36.8	22.2	23.3
EBIT interest coverage (x)	37.4	11.7	7.2	26.2	8.0
EBITDA interest coverage (x)	44.0	13.4	9.4	31.3	10.0
Return on capital (%)	27.8	19.1	18.6	26.4	25.6
FFO/debt (%)	174.9	64.0	37.3	116.2	99.7
Debt/EBITDA (x)	0.4	1.1	1.8	0.6	0.8

*Fully adjusted (including postretirement benefit obligations, capitalized operating leases, excess cash, and other items, as appropriate); detailed accounting information can be found in each company's full report--article type "Analyses"--on RatingsDirect.

Table 6

OAO NOVATEK Financial Summary*

Industry Sector: Oil & Gas Exploration & Production

		--Fiscal year ended Dec. 31--				
(Mil. RUR)	**First-half 2009**	**2008**	**2007**	**2006**	**2005**	**2004**
Rating history	BB+/Positive	BB+/Stable/--	BB/Positive/--	BB-/Stable/--	-/-/-	-/-/-
Revenues	39,976	79,272.0	62,321.0	49,373.0	38,477.0	24,615.0
Net income from continuing operations	9,312	22,899.0	18,736.0	14,079.0	13,697.0	5,694.0
Funds from operations (FFO)	13,957	28,712.9	23,156.7	17,416.0	12,682.0	4,866.0
Capital expenditures	7,964	31,596.0	19,666.0	4,770.0	4,433.0	5,362.0
Debt	41,826	27,988.4	7,907.1	3,708.6	9,094.0	24,000.0
Equity	120,093	96,434.4	81,609.2	68,676.0	57,549.0	45,072.0

Table 6

OAO NOVATEK Financial Summary* (cont.)

Adjusted ratios						
Oper. income (bef. D&A)/revenues (%)	40.2	46.6	47.0	46.8	49.4	31.3
EBIT interest coverage (x)	17.5	37.5	62.1	24.4	17.9	10.3
EBITDA interest coverage (x)	20.9	44.1	71.3	29.6	17.4	9.1
Return on capital (%)	21.1	28.5	29.3	25.1	26.2	17.9
FFO/debt (%)	66.7	102.6	292.9	469.6	139.5	20.3
Debt/EBITDA (x)	1.3	0.7	0.3	0.2	0.5	3.0

*Fully adjusted (including postretirement obligations). RUR--Russian ruble.

Ratings Detail (As Of September 10, 2009)*

OAO NOVATEK		
Corporate Credit Rating		BB+/Positive/--
Russia National Scale Rating		ruAA+/--/--
Corporate Credit Ratings History		
07-Jul-2009		BB+/Positive/--
11-Jul-2008		BB+/Stable/--
26-Sep-2007		BB/Positive/--
28-Jun-2007		BB-/Positive/--
17-Mar-2006		BB-/Stable/--
11-Jul-2008	*Russia National Scale Rating*	ruAA+/--/--
26-Sep-2007		ruAA/--/--
17-Mar-2006		ruAA-/--/--
Business Risk Profile		Fair
Financial Risk Profile		Intermediate
Debt Maturities		
At June 30, 2009 June 30, 2009-June 30, 2010: RUR22.757 bil. June 30, 2010-June 30, 2011: RUR17.45 bil.		

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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